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REPORT FROM THE COMMISSION

**to the budgetary authority on guarantees covered by the general budget
situation at 30 June 2006**

{SEC(2007) 241}

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Part One: Events since the Report at 31 December 2005, the risk situation and activation of Budget Guarantees¹

1. INTRODUCTION: TYPES OF OPERATION

The risks covered by the Union budget derive from a variety of lending and guarantee operations which can be divided into two categories: loans granted by the European Communities with macroeconomic objectives, i.e. macro-financial assistance (MFA) loans to non-member States, and loans with microeconomic objectives (Euratom and European Investment Bank (EIB) loans² in non-member States). Current risks on Member States result from loans disbursed prior to accession.

2. EVENTS SINCE THE REPORT AT 31 DECEMBER 2005

Regarding macro-financial assistance provided to third countries in the form of loans, no new Council Decision was adopted. On the basis of existing decisions, a loan disbursement of EUR 10 million was carried out in favour of Bosnia and Herzegovina, followed by a loan disbursement of EUR 9 million to Albania.

There was no disbursement in the form of grants during the first half of 2006.

Regarding Euratom, a loan disbursement of EUR 17.5 million in favour of Bulgaria (Kozloduy) and a loan disbursement of EUR 33.5 million to Romania (Cernavodă) were carried out on the basis of existing decisions which are now used up.

Concerning the EIB current mandate, the Council decided on 27 February 2006³ to amend Decision 2000/24 in order to include the Maldives in the list of countries covered, following the Indian Ocean tsunamis of December 2004. Furthermore on 22 June 2006, the Commission issued a proposal⁴ for a new EIB external mandate 2007-2013.

Under the new Financial Framework, the European Parliament, the Council and the Commission adopted an Interinstitutional Agreement on budgetary discipline and sound financial management⁵ that will enter into force on 1 January 2007. Consequently, the amount of financing of the Guarantee Fund will not be explicitly limited in the future as the funding of the Guarantee Fund will be carried out through a budget line under Heading 4 (EU as a global player) and not, as at present, through a dedicated Reserve. However, in the absence of this Reserve, the substantial elements of budgetary discipline will still be in place: the EIB's external lending mandate will be limited over the 2007 to 2013 period (this Council Decision will represent around 90% of the overall loan volume), Macro-Financial Assistance loans are

¹ Please note that the annex contains a Commission Staff Working Paper with a set of detailed tables and explanatory notes to this report.

² The details concerning the EIB mandates are displayed in Table A1 of the annex.

³ OJ L 62, 03.03.06, p.26.

⁴ COM (2006) 324 final, 22.06.2006.

⁵ OJ C 139, 14.06.06, p.1.

subject to individual decisions by the Council and the Euratom lending has a ceiling of EUR 4 billion (which has already been used to a large extent).

3. RISK SITUATION

The following risk analysis uses the established measures of capital outstanding, maximum annual risk and maximum theoretical annual risk borne by the Community budget (its methodology is explained in the Commission Staff Working Paper). Detailed figures can be found in the Annex Tables A1, A2 and A3 respectively.

3.1. Capital outstanding at 30 June 2006

The total risk at 30 June 2006 came to EUR 16,089 million, as against EUR 16,521 million at 31 December 2005.

The following table shows the operations which have had an effect on the amount of capital outstanding since the last report.

Table 1: Capital outstanding at 30 June 2006*		EUR million (rounded)
Amount outstanding at 31 December 2005		16,521
Loan repayments	Euratom	0
	Macro-financial assistance	-31
	EIB	-1,051
Loans disbursed	Euratom	51
	Macro-financial assistance	19
	EIB	1,017
Exchange rate differences between EUR and other currencies		-437
Amount outstanding at 30 June 2006		16,089

* All guaranteed loans (Member States and non-member States), excluding unpaid interests due and payment defaults.

The capital outstanding in respect of operations in the Member States was EUR 2,801 million at 30 June 2006, compared with EUR 2,966 million at 31 December 2005.

The capital outstanding in respect of operations in non-member States at 30 June 2006 was EUR 13,288 million, compared with EUR 13,554 million at 31 December 2005.

3.2. Maximum annual risk⁶ borne by the Union budget: operations disbursed at 30 June 2006 (see Table A2 in Annex)

- For the second half of 2006, the total maximum annual risk amounts to EUR 1,258 million.
- The risk in respect of Member States comes to EUR 397 million.
- The risk in respect of non-member States comes to EUR 861 million.

3.3. Maximum theoretical annual risk⁷ borne by the Union budget: operations disbursed and decided at 30 June 2006 (see Table A3 in Annex)⁸

- For the second half of 2006, the maximum theoretical risk amounts to EUR 1,323 million and is estimated to reach, under certain assumptions, EUR 2,664 million in 2014.
- The maximum theoretical risk in respect of Member States is EUR 397 million in the second half of 2006. The risk is estimated to decrease at EUR 168 million by 2014.
- For the non-member States it amounts to EUR 926 million for the second half of 2006. The risk is estimated to reach EUR 2,496 million by 2014.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources⁹ in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the Commission.

4.2. Activation of the Guarantee Fund

Council Regulation (EC, Euratom) No. 2728/94 of 31 October 1994, as amended, established a Guarantee Fund for external actions. In the event of late payment by a recipient (third countries) of a loan granted or guaranteed by the Community, the Guarantee Fund is called on to cover the default within three months of the date on which payment is due.¹⁰

During the first half of 2006, the Guarantee Fund was not called as no default occurred on such loans.

⁶ The technical term "maximum annual risk" is explained under point 1 in the Annex.

⁷ The technical term "maximum theoretical annual risk" is explained under point 1 in the Annex.

⁸ The maximum annual risk takes into account the amounts of loans remaining to be disbursed for the current financial perspectives as the new EIB Mandate 2007 to 2013 has not yet been decided.

⁹ Under Article 12 of Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000, as amended, implementing Decision 94/728/EC, Euratom, on the system of the Communities' own resources.

¹⁰ For more details, see Section 2.5. of the Annex.

5. ANALYSIS OF THE COMMUNITY'S THEORETICAL LENDING AND GUARANTEE CAPACITY IN RESPECT OF NON-MEMBER STATES

In practice, the Guarantee Fund mechanism limits the Community's lending and guarantee capacity to non-member States, since the appropriations available for provisioning the Fund are limited by the amount entered for the Guarantee Reserve in the current Financial Perspectives¹¹.

Table A4 in the Annex shows an estimate of the Community's lending capacity in respect of non-member States in 2006 in line with the current Guarantee Fund Regulation. The method of calculation and references to legal texts are set out in greater detail in the Annex.

Table 2 shows that outstanding lending and loan guarantee operations for non-member States totalled EUR 13,421 million at 30 June 2006.

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)	
1. Capital outstanding, EC (MFA), Euratom	1,504
2. Capital outstanding, EIB	11,784
3. Unpaid interest due ¹	133
Amount outstanding ² at 30 June 2006	13,421

¹ Unpaid interest due within the meaning of the Regulation establishing the Guarantee Fund.

² Payments Defaults and Default Interest are not included in the outstanding amount to be covered by the Fund and are reported separately in Section 6.

The ratio between the Fund's resources and outstanding capital liabilities, within the meaning of the Regulation establishing the Fund, was 9.85%, which is higher than the target figure of 9% set in Regulation No. 1149/1999 amending Regulation No. 2728/94 establishing the Fund. The rules state that at the end of a year the surplus shall be paid back to a special heading in the statement of revenue in the general budget of the European Union.

6. SITUATION OF THE GUARANTEE FUND AT 30 JUNE 2006

At 30 June 2006, the Guarantee Fund amounted to EUR 1,321.33 million. The following movements were recorded in the first half of 2006.

- Net revenue of EUR 24.8 million from investment of the Fund's assets as of 30 June 2006.

¹¹ The annual figure entered in the 2000-2006 Financial Perspectives is EUR 200 million at 1999 prices; in 2006, the amount was EUR 229 million.

No recovery occurred in the first half of 2006.

The total arrears, at 30 June 2006, i.e. penalties interests with the Republic of Argentina, amount to USD 1,718,493.12, thereof, USD 1,448,433.44 (EUR equivalent 1,139.332,53) are still to be recovered by the Fund. The balance is due to the EIB.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 30 June 2006 (EUR 1,321.33 million) and the maximum theoretical annual risk for loans to non-member States in 2006 (EUR 926 million) is estimated at 71% (see Annex Table A3)¹².

¹² Please note that the estimate for the maximum theoretical annual risk for the year 2006 reported in Table A3 refers to the second half of 2006 only. For reasons of comparability, this amount has been normalised on a period of 12 months for the above comparison.

Part Two: Evaluation of risks: Economic and financial situation of the non-member countries benefiting from the most important loan operations

1. INTRODUCTION

The figures in Part One provide information on quantitative aspects of the risk borne by the general budget. However, the quality of the risks which depend on the type of operation and the standing of the borrower should also be assessed. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper¹³. A brief summary of this analysis is provided below.

2. ACCEDING COUNTRIES

In the first half of 2006, real GDP growth in **Bulgaria** accelerated to 6.1% (from 5.5% in 2005). This was mainly driven by very strong gross fixed capital formation, which grew by over 20%, and by continued strong private consumption growth. The current account deficit widened further to 13.9% of GDP primarily because of a lower surplus in the services balance and lower current transfers from abroad. Growth of merchandise exports outpaced imports in the first half of 2006, which was, however, insufficient to prevent a slight further increase in the trade deficit. As in 2005, the current account deficit was almost completely covered by net FDI inflows.

For **Romania**, real GDP growth rebounded strongly by 7.4% in the first half of 2006, after a deceleration to 4.1% in 2005, mainly due to the negative impact of widespread floods and structural changes affecting industrial activity. Economic growth was fairly balanced in the first semester of 2006, being driven by both household consumption growth of 11.8% and investment growth of 11.9%. The disinflation process in 2006 was more rapid than expected and the year-on-year increase in CPI came down to 5.5% in September from 8.6% at the end of 2005. Over the course of 2006, the current account deficit continued to widen from 8.7% of GDP reported in 2005 to around 9.6% in July 2006, largely driven by substantial FDI inflows (covering more than 70% of the deficit), private sector borrowing and portfolio investments. The external debt of the country grew by around EUR 5 bn in the first half of 2006 due in particular to the short-term private external debt growing rapidly, but declined slightly to around 37% of GDP.

3. CANDIDATE COUNTRIES

For **Turkey**, real annual GDP growth amounted to 7% in the first half of 2006, as compared to 7.4% in 2005. Growth is expected to range between 5-6% in 2006. The current account deficit reached 6.2% of GDP in 2005 and is expected to stabilize in 2006, in large part as a result of improved price and cost competitiveness following the depreciation of the lira in

¹³ SEC(2007) 241

May-June 2006. Gross FDI inflows reached 3% of GDP in 2005 and in the first half of 2006, thereby financing about half of the current account deficit. The external debt of the country amounted to roughly 40% of GDP at the end of 2005.

For the **former Yugoslav Republic of Macedonia**, GDP growth decelerated to 2.6% (in real terms) in the first half of 2006, compared to 3.8% during the same period a year ago. Main factors for this slowdown were weaker industrial production and construction. However, leading indicators point to a marked acceleration of industrial output during the third quarter of 2006, which could bring overall GDP growth in 2006 to close to 4%. The current account deficit improved significantly in 2005, when a better trade performance and stronger inflows of workers remittances reduced the deficit from 7.7% of GDP in 2004 to 1.4% of GDP in 2005. In 2006, a widening to 2-3% of GDP is expected. Gross FDI inflows amounted to 1.7% of GDP in 2005, but rose sharply to about 6% of GDP during the first half of 2006, resulting from a substantial privatisation related FDI inflow. The external debt of the country amounted to 47% of GDP at the end of 2005.

4. POTENTIAL CANDIDATE COUNTRIES

In **Albania**, annual GDP growth amounted to 5.5% (in real terms) in 2005. The current account deficit (including official transfers) reached 6.9% of GDP in 2005. The trade deficit stood at 24.1% of GDP in 2005 and during the first five months of 2006, it widened further by 18% on an annual basis). Gross FDI inflows reached 3.1% of GDP in 2005 and the external debt of the country amounted to 17.6% of GDP at the end of 2005. Total public debt declined to 55.3% of GDP in 2005.

In **Bosnia and Herzegovina**, annual GDP growth amounted to around 5.5% (in real terms) in 2005. Growth is expected to remain around 5% in 2006. The current account deficit widened to 22.5% of GDP in 2005, partly reflecting effects of VAT introduction on import flows. It narrowed again in the first half of 2006 and is expected to be around 20% at year end. Gross FDI inflows reached 3.2% of GDP in 2005. Public external debt of the country amounted to 30% of GDP at the end of 2005, while private external debt was estimated to also amount to around 30% of GDP.

In **Serbia**, annual GDP growth amounted to 6.3% (in real terms) in 2005. Growth continued at 6.3% in the first quarter of 2006. The current account deficit reached 9.8% of GDP in 2005. It widened further in the course of 2006. Gross FDI inflows reached 6.1% of GDP in 2005 and the external debt of the country amounted to 66% of GDP at end-July 2006. Public debt has declined following the EUR 600 million Paris Club debt write-off, which was linked to the successful completion of the recent IMF programme in February 2006.

In **Montenegro**, annual GDP growth amounted to 4.1% (in real terms) in 2005. Growth accelerated to 6.5% in the first semester of 2006. The current account deficit reached 12.2% of GDP in 2005. It further widened in the course of 2006. Gross FDI inflows reached 22.8% of GDP in 2005 and the external debt of the country amounted to 42.6% of GDP at the end of 2005. In July 2006 Montenegro reached an agreement with Serbia on the division of financial rights and obligations following the dissolution of the former state union. The agreement confirmed the previous estimates of the debt levels.

5. NEW INDEPENDENT STATES

In **Georgia**, despite the external shocks, economic growth still appears relatively resilient after very strong growth of 9.3% in 2005, inflation peaked at 14.5% in mid-2006 and the main economic policy challenge is to bring inflation back to single digits. The trade balance deteriorated and can be projected at 19% of GDP (14.6% in 2005). Growing remittances and official transfers cushion the impact on the current account which nonetheless is expected to have a deficit of 10% of GDP this year (5.4% in 2005). Thanks to strong economic performance Georgia's external public debt has been rapidly reduced to around 23% of GDP (27% in 2005).

In **Ukraine**, the economy appears to have adjusted quickly to the increase in oil and gas import prices and a rebound in growth was seen in the first half of 2006 (5.5% year-on-year against 2.6% in 2005 as a whole). The current account has turned negative, also related to concomitant market developments in steel, Ukraine's main export. Ukraine's public external debt has declined to 12.5% of GDP (15.3% in 2005), while the private sector's better access to foreign capital markets keeps the total external debt at around 45% of GDP. Higher producer prices have not yet impacted consumer prices, which fell back to single digits in mid-2006. In August, Standard & Poor's confirmed, however, Ukraine's sovereign long-term credit rating at BB-, supported by the low level of indebtedness in particular.

Moldova's GDP growth that had exceeded 7% in 2005 is expected to slow down to 3% in 2006. This is the result of the strong external shocks faced by Moldova's economy – the doubling of the price of the natural gas imports from Russia and the ban imposed on Moldova's wine exports. In 2006, the trade and current account deficits are expected to exceed respectively 50% and 10% of GDP. Also, inflation is expected to rebound to more than 12% this year. The deterioration of Moldova's external economic environment comes at a moment the country has finally succeeded in restructuring its Paris Club debt and is set to gradually cut down its external indebtedness.

Tajikistan's economy has continued to grow strongly in 2005-2006 by 7% to 8%. The government budget that was in surplus for three consecutive years (2003-2005) is expected to register a moderate deficit in 2006. Thanks to the successful bilateral debt agreement with Russia – Tajikistan's largest creditor – external debt has fallen to less than 40% of GDP in 2005. A deteriorating trade deficit (from 7% of GDP in 2004 and 12% in 2005 to the projected more than 16% in 2006) is largely offset by a rapid growth in foreign remittances. As a result, the current account deficit is expected to increase moderately in 2006 (from 3.6% in 2005 to about 4.5%). Import coverage of gross official reserves remains relatively low, at slightly less than two months of imports. The IMF PRGF arrangement was successfully completed in early 2006. The authorities have started the preparation of a successor arrangement.

6. OTHER NON-MEMBER COUNTRIES

Algeria experienced a major political break in 2005 as President Bouteflika moved to bring the “national tragedy” of the 1990s to a close stressing the need to economic development. Record oil prices have meant unprecedented stability and prosperity for the Algerian economy, as well as a golden opportunity for reform. The government's \$60bn spending programme targeting infrastructure, housing, education and jobs training should help to make long-term growth sustainable. However, despite the liberalisation of the banking sector in

1990s, the Algerian financial market remains significantly underdeveloped. Moreover, with only three stocks traded and a market capitalisation of \$1.4bn, the Algiers Stock Exchange remains something of a fledgling market. With accession to the World Trade Organisation (WTO) on the horizon and the EU Association Agreement now in force, Algeria has clearly signalled its move to free markets and free trade. The major challenge for the country now appears to be consolidating and speeding up the process of reform started in recent years.

Jordan's economy continues to grow strongly in 2006, with real GDP growth in the first quarter of 2006 at 6.7%. The unemployment rate remains high (reaching 15.7% in 2005). The inflation rate is expected to pick up in 2006 to 6.3% (2005: 3.8%). The authorities have intensified fiscal adjustment in 2005 and 2006 to bring the budget deficit (excl. grants) down to 6.6% of GDP from 10.1% in 2005. External current account deficit (incl. grants) for 2006 is expected to increase from 18.2% in 2005 to 20.7% of GDP (and compared to a surplus of 11.6% in 2003). Although merchandise export growth remained robust, the trade deficit widened to 38.8% of GDP in 2005 (2004: 29.6%) on account of an important increase in imports reflecting strong domestic demand growth, higher oil prices and the high import content of exports. The current account deficit continued to be financed by capital inflows, including foreign direct investments, remittances and portfolio inflows primarily from the region. At the same time, the real effective exchange rate is expected to appreciate after years of depreciation.

Brazilian's growth is expected at 3.5% in 2006 and inflation has declined to its lowest level since the adoption of the inflation targeting regime. Buoyant export growth and rising commodity prices have allowed the country to run an important current account surplus (projected at 1.1% of GDP in 2006). The external debt-over-GDP ratio has decreased and is projected to further decline to 21.1% by the end of 2006. Efforts to reduce public external indebtedness are paying off: Brazil's sovereign credit has been upgraded by two of the leading credit-rating agencies since February 2006, and interest premia are at historically at low levels. Significant external vulnerabilities remain, however, despite recent progress with public debt management. Public debt remains above 50%, is highly exposed to interest rate variations with a relatively short average maturity.

The **Argentinean** economy is expected to expand by 9.2% in 2005. Inflation at end-2007 is expected to reach 12%. The strength of the economy has led to a significant improvement in public finances, with the primary surplus expected to reach about 4.5% of GDP in 2005. The banking sector is recovering gradually but is still weak. Uncertainties concerning the legal framework and the government policy for the public utilities have persisted and continue to have detrimental effects on the confidence of foreign investors. In addition, the fact that the country no longer needs to turn to the IMF after fully repaying all its IMF debt in December 2005 do not appear conducive to progress on structural reforms to address long-term vulnerabilities. Argentina remains in arrears to the EIB, having failed to pay the penalty interest (USD1.7 million) steaming from the arrears that the state run in the wake of the Argentinean financial crisis.